Report
Dynamo 26
PUBLISHED BY DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA. – 1st QUARTER 2000 www.dynamo.com.br

Controlling Premium in Brazil: Why, How and To Whom

Political science usually classifies governing systems based on how power is distributed within the societies: if it belongs to only one person, it is called monarchy; if it belongs to a few persons, it is called aristocracy; if it belongs to several people, it is called democracy. Corporations in general, and even more so if they are publicly-owned, constitute societies. For this reason, the analogy is almost perfect: if the power within a firm belongs to only one person, we have the "owner's company"; if it belongs to a few shareholders, we have a controlling block (usually through a shareholder's agreement); and whenever the power belongs to several shareholders, we have a corporation.

The corporation, like the democracy, is more typical of developed countries. In these markets, the governance activities from shareholders is targeted at the managers since the potential conflicts tend to arise mainly from how executives and shareholders divide the gains generated by the company.

In Brazil, when we talk about corporate governance, we are restricted to analyzing the monarchic structure of an owner's company or, more recently, the aristocratic structure of a controlling block. In these cases, the fundamental problem of governance is still centered on the conflicts of interests between the controlling and so-called minority shareholders (even though they usually have the majority of capital). In this chapter of our capital markets history, as a confirmation of our less than ideal regulatory framework - although recognizing the endless creativity of our controlling shareholders - we could mention a very diverse list of puzzles. However, we intend to deal in this report with only one of them: the enormous difference between the value of controlling and non-controlling shares in Brazil or, in other words, the controlling premium.

Before we start, we need to clarify what we call the controlling premium. We are referring to the additional value, in relation to the market price, one pays to acquire 50.1% of the voting shares of a given company. Is it reasonable for such premium to exist? We believe that it is if the acquirer believes that his management will bring about more value for the acquired company than the premium he paid. But it is not the existence of the controlling premium that creates the conflicts; rather, it is how such premium is distributed among all shareholders. This distribution will depend on the legal framework of the country in which the transaction occurs but, at least in principle, there are gains to be appropriated by everyone involved: the acquirer, the seller and the minority shareholders since if the company really improves with the new owner, these new profits will somehow be transferred to all shares. It is exactly for this reason that abnormally high premia should not exist as (1) the seller will ask for a price as high as his expectation about the gains to be achieved by the acquirer, and (2) if and when such gains are perceived by the market as realistic and benefiting all shareholders, the price of the non-controlling shares will go up, effectively reducing the controlling premium.

There is no legal or empirical rule on what should be an acceptable control premium, but in more developed markets, the range of 20-25% happens with enough frequency that it seems reasonable. As such, how can we explain the triple digit premia that have been paid recently for the acquisition of the control of Brazilian companies, as is shown in the table below?

Why should a few shares in a company be worth so much more than all other shares just because they grant its holder the rights for electing the majority of board members and to approve proposals voted in the Shareholder's Meetings? In this case, we cannot help but talk about possibilities that are much less technical than the fundamentals we mentioned above to explain the existence of a control premium in more modern markets.

There is a vast repertoire of legal and illegal tropical ways to expropriate minority shareholders, such as: dealings with companies owned by the controlling shareholder, unnecessary retention of cash, investment opportunities taken by the controlling shareholder, unjustified dilution, extension of loans to the controlling shareholder, payment of such loans with over-priced assets, management fees paid to the controlling shareholders, payment of personal expenses, etc.... We should also add to this long list benefits that are privately appropriated by the controlling shareholder even though they were actually made possible by the company, the most obvious of which are the ones associated with political campaign contributions. It would not be difficult for us to describe in detail each of these procedures since most of our corporate governance effort is directed at analyzing and questioning them. However, we do not feel that this digression would be necessary for a full understanding of the theme of this report. In addition, some of the papers we will refer to in this Report analyze these private gains associated with controlling more thoroughly and competently.

All these artifices to create a disproportionate value for controlling shares (which the academic literature has coined

the appropriate name of "tunneling") are empirically analyzed in one of the most complete studies of corporate governance that we have had access to. We are referring to a series of papers published in the end of 1999 by three Harvard and one Chicago professors, respectively, Rafael la Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny. In one of the papers entitled *"Investor Protection: Origins, Consequences and Reform"*, the authors state that *"... when investor rights are poorly protected and expropriation is feasible on a substantial scale, control acquires an enormous value because it gives the insiders the opportunity to expropriate relatively efficiently. If the insiders actually do expropriate, the so called private benefits of control become a substantial share of the firm value"*. Bringing back our earlier analogy with the historical systems of government, we could say that the possibility of building a disproportionately large cash flow for the controlling shareholders causes companies to be structured more in the direction of a monarchy and away from a true democracy since *"... the legal environment shapes the value of the private benefits of control, and therefore determines the equilibrium ownership structure"*. These quotes seem very appropriate to explain, at least partially, one of the main causes of the aristocratic character of the majority of Brazilian companies as, quoting the professors one more time, *"... countries with poor investor protection typically exhibit more concentrated control of firms than do countries with good investor protection"*.

In another paper (Investor Protection and Corporate Valuation) the same authors study a sample of 380 companies in 27 different countries. With respect to the specific issue of control value in different markets, the authors conclude that *"Our study ... tends to find higher voting premium in countries with inferior shareholder protection"*. The table below, which contains the premia paid in recent transactions in Brazil, seems to illustrate well both sides of this equation: enormous premia paid in an environment of insufficient legal and regulatory protection for non-controlling shareholders. The high voting premium so common in Brazil is an unambiguous indicator of the practice of discriminating returns for shareholders. It is also a decisive contributor for the underdevelopment of our capital markets and, hence, for the lack of true corporations or, at least, companies with more diverse controlling blocks since *"... expropriating outside investors - even legally - may require some secrecy, which mediates against shared control"*. A curious effect of such factor is that family-owned companies are more likely to become corporations or to be sold as generations pass and families get more numerous.

The expropriation of minority investors by controlling shareholders - for which the professors even derive a mathematical model through the "cost of theft" function - as a cause for high voting premia is an issue serious enough to deserve a close scrutiny from regulators. But the problem does not stop there.

There is still another important aspect of this issue that may even be independent of how aggressive the controlling shareholder is. In the wake of recent sales of Brazilian companies to multinationals, these new owners usually want to acquire a significant portion of the target company and not just the controlling block which may represent a small fraction of total capital. This is particularly so when the new owners are not familiar with the expropriation methods frequently used here and would like to align their cash flow rights to their voting rights. Although our law does not permit multiple voting shares, through the issuance of preferred shares, one can control 51% of the voting rights with just 16.7% of the cash flow rights. For the acquirer, what matters is the average price paid for the purchase of a given amount of shares provided that such amount includes 51% of the voting shares. This creates a conflict of interest that is impossible to resolve.

Let's look at an example. Imagine a company with 1/3 of the capital in voting shares and 2/3 in non-voting, and where the controlling shareholder owns 70% of the voting shares. If an acquirer desires to purchase 60% of the capital, it will have to purchase approximately 50% of the minority shares in addition to the controlling shares. Obviously, the less it pays for the minority shares, the higher the premium it may pay for the voting control. Assuming that there is a pre-set maximum amount the buyer

Controlling Premium Estimation Paid in Brazilian Market in Recent Transactions (price in R$)

Company	Sector	Date Of The Annoucement	Price Paid (ON's)	Market Price*	Control Premium**
Refripar	Appliances&Electronics	11/01/96	2,83	2,04	39%
CST	Steel	25/04/96	40,85	17,68	131%
Metal Leve	Auto Parts	11/06/96	38,43	9,41	308%
Lacta	Food	28/06/96	15,28	2,14	614%
Casa Anglo	Retailing	15/08/96	374,36	43,73	756%
Fertisul	Fertilizer	31/10/96	5,64	2,52	123%
Arno	Appliances&Electronics	23/03/97	828,26	225,88	266%
Cofap	Auto Parts	16/10/97	30,30	8,25	267%
Varga Freios	Auto Parts	23/10/97	177,80	65,12	173%
Ceval	Food	19/11/97	27,35	5,84	368%
Agroceres	Fertilizer	25/11/97	25,40	15,50	64%
BCN	Bank	02/12/97	19,04	5,13	271%
Multicanal	Cable TV	23/12/97	1,40	0,62	125%
Tibrás	Chemical	03/06/98	110,00	18,00	511%
Pão de Açucar	Retailing	10/08/99	85,50	38,50	122%
Iven	Utilities	26/08/99	2.412,71	200,00	1106%
Manah	Fertilizer	12/04/00	215,80	35,92	501%

Source: Economática, Dynamo estimations.

* Price of the most liquid class of the referred stock ** Premium over the market price

is willing to pay for the 60% block, minority investors and controlling shareholders are inexorably sent into a zero-sum game. The situation could hardly be worse in terms of conflicting interests. The usual punishment imposed by the market on misbehaved controlling shareholders - the increases in their cost of capital through a reduction of their share price - becomes a bonanza for voting investors since it will allow them to receive the highest premium possible for their shares. This creates a compelling incentive for the fabrication of false bad news and for cooking the books (please refer to the Our Performance section in this Report). Having understood this rationale, it should come as no surprise that we find ourselves too frequently in the weird position of convincing executives that their company is actually doing much better than they are trying to convince us. This is a very common scenario when companies are trying to go private by buying back their shares at the lowest, and not the fairest, price possible.

Another important outcome of the temptation to achieve a high control premium is the preference from minority investors for higher dividends as opposed to the investment compulsion of the controlling shareholder. To the former, dividends are an immediate and proportional appropriation of the companies' assets, which is not contaminated by the discriminating valuation of their shares. To the latter, new investments, even in projects with mediocre rates of return, may be very advantageous as they increase the basis over which he will be able to charge a premium when he decides to sell the control of the company in the future. Naturally, high-return projects are also in the interest of minority investors; however, in their analysis, they will have to take into account the possibility of not being able to realize such future gains if they get squeezed-out in an eventual mid-way sale of control.

When we add up everything that was mentioned above, the rationale for the record voting premia recently paid for companies in Brazil becomes reasonably evident. However, if on the one hand the picture is not a bright one, on the other hand, the three-digit premia are not an epidemic tropical insanity caused by some strange virus but, rather, a well-calculated average price strategy employed within an unregulated environment. Consequently, legal and institutional changes may suffice to correct this anomaly. At Dynamo, we always prefer to invest in companies with fair, investor-friendly corporate policies where problems with the controlling shareholders are marginal. We try to stimulate them to make their good intentions explicit in the companies' by-laws as a way to reduce their future cost of capital. In this respect, we highlight the next section of this report, which describes recent changes in Ultrapar. Together with Saraiva, they are the only two Brazilian companies to have extended tag along rights to minority shareholders. Not coincidentally, the two companies are important positions of our fund.

The distortions surrounding the inflation of voting premia constitute one of the various problems of the Brazilian capital markets which the government seems committed to resolve. It also justifies the support from the Central Bank and the CVM to the project currently being analyzed in Congress to improve several aspects of our corporate law (which we mentioned in our last edition). The commitment by the government to reform our capital markets is not limited to this project; it has been reported that it is also analyzing alternatives to increase the authority of the CVM and, even, the creation of courts specialized in corporate law. To finance the growth of our country, first we need to reduce the distance that still separates our companies from the modern democracy of true corporations and, consequently, from its benefits.

The Changes in LTRAPAR

Simultaneously with the announcement of its 1999 results, the Ultra group also published a so-called Relevant Notice which contained a landmark decision. With the objective of thoroughly aligning the interests of all shareholders, the controlling shareholders of the company signed an agreement through which they extended tag along rights to minority investors of Ultrapar.

In practice, this means that if the voting control of Ultrapar is sold, directly or indirectly, the acquirer is required to make a tender offer for all shares (preferred and common) of the company in the exact same terms and conditions it offered to the controlling shareholders. Or, said in another way, the control premium eventually paid for the acquisition of Ultrapar will be equally distributed among all its shareholders.

At first glance, some investors might feel uncomfortable with the fact that the tag along was not included in the by-laws of the company but rather in shareholders' agreement. However, after a careful analysis of the agreement, which was drafted with the advice from Mr. Bulhões Pedreira, co-author of Brazil's Company Law and one of the most respected corporate lawyers in Brazil, investors will conclude that its is as efficient as if the tag along was built in the company's statutes. The irrevocability of this right is assured by the fact that the agreement grants the status of a "settlement in favor of third parties", a mechanism included in the Brazilian Civil Code. Even so, the question remains: why include it in the agreement and not in the by-laws? The answer lies in the recent corporate history of the company, which we outline below.

In 1984, Mr. Pery Igel, then the controlling shareholder of Ultra, began to implement his succession plan which called for the company to be run by the executives and co-controlled by them and Mr. Igel's descendents. The plan, which did, in fact, allow for a smooth transition after his death in September of 1998, can be summarized as follows. Two holding companies were created; the first one, called Igel Part., was owned by his family members and had 49.5% of Ultra S/A (which controls Ultrapar); the other, called Avaré Participações, had 69% of its capital in the hands of the executives (the remaining shares belonged to an old partner of Mr. Igel, Mr. Beltrao, and to Mr. Igel himself), and also had 49.5% of Ultra. On top of his participation in Avaré, Mr. Paulo Cunha, the CEO of Ultra, is also the beneficial owner of 0.8% of Ultra S/A, which was transferred temporarily to him by Mr. Igel. In 2004, Mr. Cunha will loose the beneficial ownership of these shares, both holding companies will be liquidated and all shareholders will receive shares directly in Ultra S/A, as is shown in the chart below.

If the tag along right were to be granted in the by-laws of Ultrapar, it would be necessary to prevent the indirect change of control that will occur in 2004 from triggering the tender offer. Since the by-laws cannot distinguish between individual shareholders, the legal advisers of the company recommended that the tag along be built through shareholders' agreement which was signed by all individual shareholders involved. It is important to emphasize that this agreement has no expiration date, and can only be revoked if the tag along is included in the by-laws of Ultrapar, such inclusion to

be approved in a Shareholders' Meeting where only the holders of preferred shares will be eligible to vote. In sum, from our perspective, the controlling shareholders of Ultrapar have set a new paradigm.

With respect to the fundamentals of the company, we remain optimistic. The company is involved in petrochemicals (through Oxiteno) and gas (LPG) distribution (through Ultragaz). Many investors tend to over-emphasize the importance of the petrochemical business of the company. We really like the LPG distribution business as it generates a stable cash flow, has a strong brand franchise and high growth potential arising from the opportunistic targeting of deregulation initiatives.

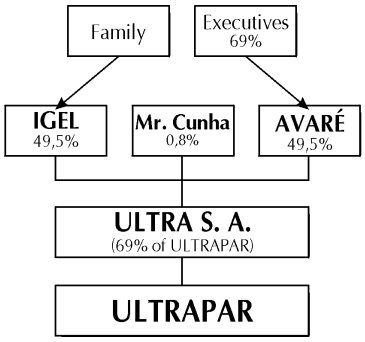
The opening of the market for LPG is creating new venues for growth. Under the old market structure, companies were limited both in their selling prices and in the geographical regions they were allowed to operate. As prices are no longer controlled and companies are now free to enter new markets, we think that Utragaz' strong distribution network and healthy financial situation should give them a competitive edge in the shakeout of the sector.

In the petrochemical sector, in addition to a cash balance of over US$ 230 million, Oxiteno has a pretty comfortable market position. Being the only producer of ethylene oxide in the country, the company has kept its production capacity 30% above the internal market demand as a way to avoid new competitors entering the market. The company has also been analyzing the possibility of leading the process of consolidating the various companies operating in the Polo de Camaçari. Because of the uncertainties associated with the sale of Norquisa, the key starting point of the whole process, we do not consider the potential upside of this project in our projections. Even so, we believe that this restructuring could be a great opportunity for the company to create value for its shareholders.

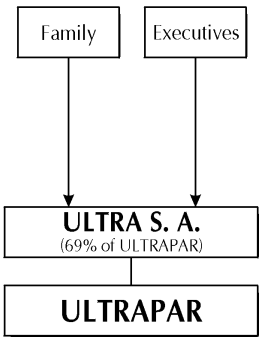
The company is trading at very attractive multiples. We are projecting a proportional Ebitda of US$ 130 million for 2000 and, at the current price (US$ 9,50), the EV / Ebitda multiple is only 2.5. With a market capitalization of US$ 500 million, the estimated P/E for 2000 is only 6.4.

Summing up, the company boasts what we consider a full package of excellent fundamentals: a good business with a dominant market position, growth potential, strong management focus on shareholder value, alignment of interests between controlling and minority shareholders, and an appealing valuation.

Before 2004



After 2004



Dynamo Cougar x Ibovespa x FGV-100

(in US$ dollars - commercial selling rate)

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94
1993	-	38,78	38,78	-	9,07	9,07	-	11,12	11,12
1994	-	245,55	379,54	-	165,25	189,30	-	58,59	76,22
1995	-	-3,62	362,20	-	-35,06	87,87	-	-13,48	52,47
1996	-	53,56	609,75	-	6,62	100,30	-	53,19	133,57
1997	-	-6,20	565,50	-	-4,10	92,00	-	34,40	213,80
1stQuar/98	16,55	16,55	675,66	18,15	18,15	126,83	15,07	15,07	261,14
2ndQuar/98	-8,70	6,40	608,30	-19,40	-4,80	82,80	-19,60	-7,50	190,30
3rdQuar/98	-33,50	-29,20	371,20	-27,20	-30,70	33,10	-33,40	-38,40	93,50
4thQuar/98	14,20	-19,10	438,10	-1,20	-31,50	31,50	-0,10	-38,40	93,30
1stQuar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2ndQuar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3rdQuar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4thQuar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58
1stQuar/00	6,15	6,15	1068,96	11,53	11,53	217,56	7,08	7,08	250,77

(*) The Dynamo Cougar Fund figures are audited by KPMG and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.
(**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.